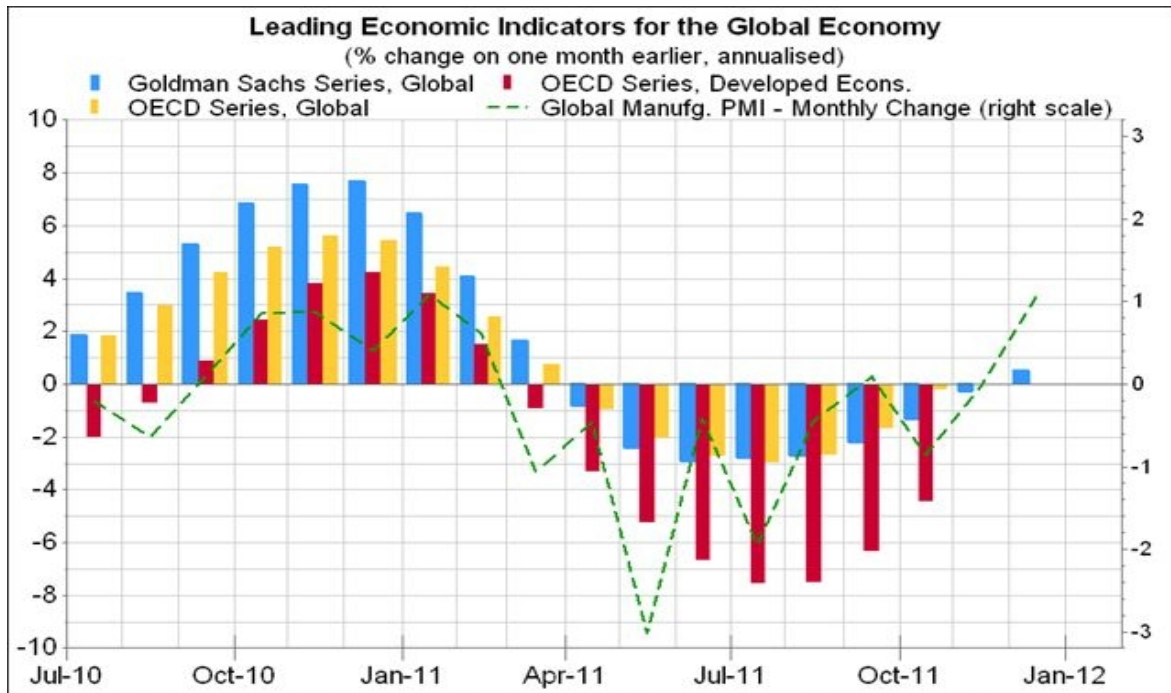




## K2 Equity Market Outlook 13<sup>th</sup> January 2012

With visibility into 2012 low, we thought it worthwhile making a couple of key points as to the outlook for growth and the valuation of markets going forward.

**Internationally leading indicators of economic growth are actually accelerating not decelerating.** Despite the press regularly flagging the world is entering a 2<sup>nd</sup> global recession and growth forecasts for 2012 currently being downgraded, it may surprise many to see that most leading indicators of industrial production have actually improved over the last 6 months and have recently flagged an acceleration of global activity not a deceleration of global activity. Clearly Europe is not participating in this move, but US growth has continued to surprise on the upside, while Chinese growth has encouragingly begun to stabilize in the face of some more proactive policy action from the central authorities.



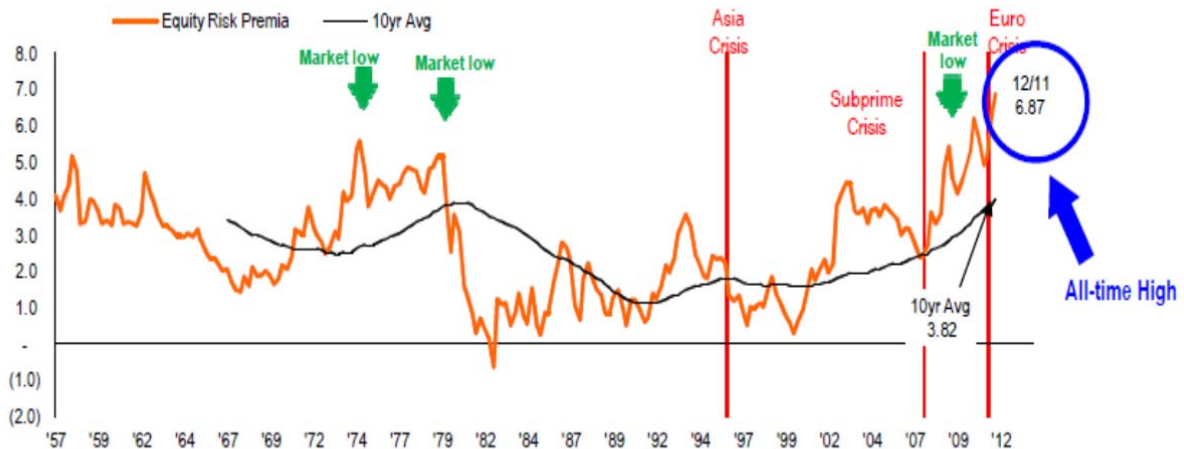
Source: Financial Times, 2012

**Valuation is attractive.** For those who read our Monthly Reports, we repeatedly highlight how cheap stocks are versus history and especially versus other asset classes. The best way to show this graphically is via the 'equity risk premium', which for the S&P 500 is currently at its highest point ever at 6.87% (see below). This implies that the

discounted value of equities is at a huge premium to the risk free rate i.e that equities are offering a record earnings yield over bonds for those brave enough to invest rather than sit in cash. The equity risk premium is so high partly because equities are at an appealing valuation, but also because the lower risk alternatives are providing such unappealing returns.

**Figure 12: Equity Risk Premium**

Using a Dividend Discount Model to derive the real S&P 500 Equity Discount Rate implied by S&P 500 prices. The Equity Risk Premium is the difference between the Equity Discount Rate and the 10-yr real bond yield (10-yr nominal UST yield minus 10-yr Philly Fed inflation expectations) (which is the risk-free rate)



Source: J.P. Morgan Global Asset Allocation Team.

**Europe is still a problem.** The challenges facing the European financial system should not be underestimated. Large amounts of sovereign debt, excessive bank leverage and an inflexible monetary and political system have combined to create in essence a ticking financial bomb that policy makers have so far been unable to deactivate. We still maintain that the policy tools are available to combat this crisis, as proven in both the US and the UK during 2008. However, to date policy makers in Europe have frustratingly been unwilling or unable to enact these solutions. Looking ahead, the re-emergence of these problems is inevitable. The question remains how much pain Europe needs to go through before policy makers can agree on a credible path to fiscal union, Eurobonds and sovereign bond buying from the central bank.

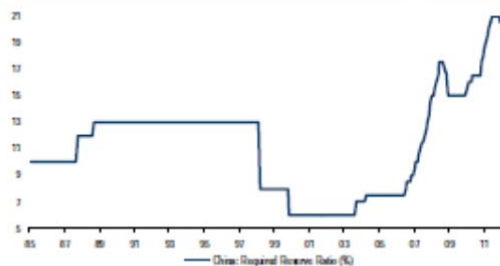
From our point of view, broad international economic growth remains reasonably robust in the face of multiple headwinds; this is the private sector at work, continuing to invest in spite of the cloudy outlook. Valuation is cheap and extremely cheap versus alternatives; the reward for investing in high quality dividend paying stocks on a global basis has never been higher and since cash is offering increasingly minimal returns, the math for investing remains attractive. Europe is a tail risk, which is likely to re-emerge and hence needs to be managed carefully. Consequently



we are maintaining a neutral position to global equity markets (75% exposure) with bias to the upside once Europe becomes clearer. Over the medium term we remain convinced equities are the asset class of choice and remain committed to finding the best equity stories the world has to offer.

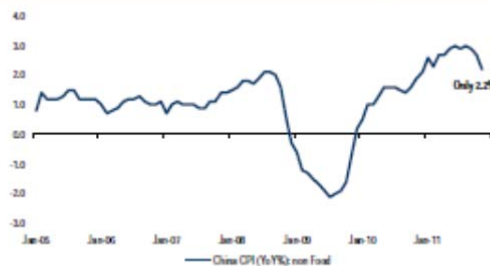
**In Asia**, despite a volatile and ultimately disappointing 2011, we remain positive on the outlook for Asian equity markets. Chinese GDP slowed to 9.4% in the 3<sup>rd</sup> quarter 2011 and it is likely to have slowed even further in the fourth quarter of last year. Nevertheless, looking forward we expect growth to bottom out in the first quarter of this year. The most recent PMI ticked up to 50.3 from the previous month's 49.0, but the main reason for our optimism is the recent fall in Chinese inflation and consequent move to an easing bias by policymakers (refer charts below).

Figure 8: China RRR (reserve ratio requirement)



Source: CEIC, Datastream, Credit Suisse estimates

Figure 9: China CPI ex food (year-on-year %)



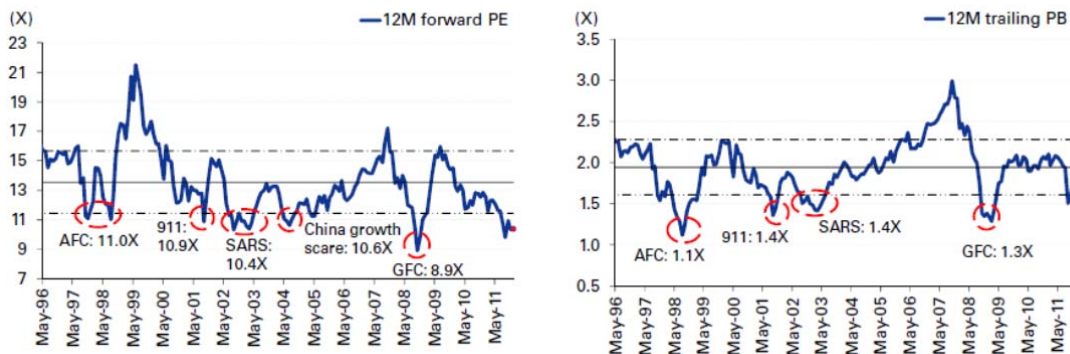
Source: CEIC, Datastream, Credit Suisse estimates

Policymakers have until recently been focused on controlling inflation and curbing property speculation, however there is now scope for an increased focus on supporting economic growth. In acknowledging this, the PBoC recently cut the Required Reserve Ratio (RRR) by 50bps. This was the first cut in three years and marks a significant shift to an easing bias and we believe additional cuts are likely over the coming months. This shift in policy stance is further evidenced by a higher than expected December increase in new lending and money supply. We also expect fiscal easing with a supportive property and public spending cycle in 2012. All of this gives us confidence that the Chinese "hard landing" feared by the market will be avoided and importantly periods of monetary easing have historically been associated with positive equity performance (i.e. "don't fight the fed").

In a further important development, Chinese policymakers recently pledged to bolster A-share market sentiment. Premier Wen Jiabao has promised to boost stock market confidence during the 12<sup>th</sup> Five-year plan and the head of the China Securities Regulatory Commission (CSRC) also recently spoke about a range of capital market reforms. Significantly 22 listed Chinese companies have begun buying back A-shares during January 2012, something which was absent in 2011. In our view, these are all positive developments which will help improve investor confidence.



**Exhibit 9: Asian valuations are 1-2 standard deviations to the inexpensive side of their historical ranges**  
12M forward P/E and 12M trailing P/B of MSCI AC Asia Pacific ex Japan index



In conclusion, policymakers are increasingly intent on supporting economic growth and restoring investor confidence. With equity valuations now well below long term average (see charts above), and inflation and interest rates as tailwinds, we believe there is a supportive backdrop for positive Asian equity performance over the year ahead.

**In Australia**, despite the relative strength of the economy we have for some time maintained the view that EPS projections for the Australian equity market appear too optimistic. We are mindful that most economists continue to project in-excess of 3% growth in GDP for 2012; we feel that an outcome of closer to 2% will prevail. In addition, secondary equity raisings have not abated. Since the GFC emerged in 2007, the number of shares on issue in Australia has surged by 67% and over \$250b of new equity has been required. Accordingly, we struggle to see why brokers forecast FY2013 EPS to be more than 15% higher than FY2011.

ASX Top 100	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
Median EPS growth vs pcp	9.9	7.8	1.7	-14.3	5.5	4.3	5.0	10.7
# companies UP vs pcp	61	56	46	29	53	53	64	88
# companies DOWN vs pcp	21	27	40	61	39	39	29	5
% of companies with lower EPS	26%	33%	47%	68%	42%	42%	31%	5%

We will be closely monitoring the forthcoming profit reports for the half year to December 2011. We believe that margin expectations are too high and should subsequently lead to downgrades to FY2012 projections. Share prices already partly reflect profit concerns. Hence it is likely that we will increase our exposure as EPS growth assumptions flatten.

We recognise the last 12 months have been a difficult time for investors. As per this outlook, we believe there are compelling reasons that make equities attractive relative to other asset classes. We remain committed to our process of managing our net equity position whilst seeking out the best companies in global markets, including Australia. We are vigilant in our determination to achieve the best outcomes for investors.



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